

GAO

Report to the Ranking Minority Member,
Committee on Commerce, House of
Representatives

March 1995

INSURANCE REGULATION

Observations on the Receivership of Monarch Life Insurance Company





United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-259883

March 22, 1995

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

Dear Mr. Dingell:

On May 30, 1991, Monarch Life Insurance Company of Springfield, MA, was placed in receivership by the Massachusetts Division of Insurance. State insurance regulators initiated this action to protect the policyholders and safeguard Monarch Life from the financial difficulties of its parent company, Monarch Capital Corporation ("the holding company"). You asked that we examine whether the actions of the parent holding company or affiliated companies endangered the solvency of Monarch Life and evaluate the adequacy of regulatory oversight leading up to the insurance receivership.

Results in Brief

Real estate investment losses of the parent holding company endangered Monarch Life's solvency and led to the regulatory takeover. The holding company pledged its Monarch Life stock as collateral on a loan, exposing the insurer to possible takeover by the holding company's creditors. As of September 1990, the holding company had diverted nearly \$165 million from Monarch Life to fund its real estate activities but could not fully repay the cash, which represented over 110 percent of the insurer's reported capital and surplus. Monarch Life also lost \$54 million on investments in affiliated real estate ventures and faced additional risk by acting as a loan guarantor for the holding company's real estate operations.

The Massachusetts Division of Insurance was unaware of Monarch Life's solvency problems until November 1990, when the holding company disclosed its inability to repay loans from Monarch Life. Until then, Massachusetts regulators lacked crucial information about the risks of Monarch Life's transactions with affiliated companies because the insurer's statutory financial statements neither revealed the magnitude of its loans to the holding company nor disclosed other interaffiliate transactions. The regulatory examination completed in January 1990 did not detect the risks facing Monarch Life because examiners did not assess whether the holding company could repay money borrowed from the insurer. Once the holding company publicly announced that its financial

condition endangered Monarch Life's solvency, Massachusetts regulators moved swiftly to protect the insurance policyholders.

In November 1993, Massachusetts expanded its regulatory authority to prevent potentially abusive interaffiliate transactions involving insurance companies. However, the regulatory approach in Massachusetts continues to rely on insurer disclosure to enforce insurance holding company laws. Timely verification of insurer-reported data about interaffiliate transactions would allow regulators to monitor more effectively and help prevent future interaffiliate dealings that could undermine insurer solvency.

Background

At the time of the regulatory takeover, Monarch Life was domiciled in Massachusetts and licensed in all 50 states and the District of Columbia. Monarch Life was subject to solvency monitoring in each state in which it was licensed. As the state of domicile, Massachusetts had primary responsibility for taking action to resolve the insurer's financial troubles. As of December 1990, about 5 months before it entered receivership, Monarch Life reported assets of \$4.5 billion. The insurer's business included variable life insurance, annuities, and disability insurance. As a wholly-owned subsidiary of the holding company, Monarch Life, in turn, owned two life insurance company subsidiaries: Springfield Life Insurance Company, Incorporated, domiciled in Vermont, and First Variable Life Insurance Company, domiciled in Arkansas. Springfield Life was placed in receivership by Vermont regulators in May 1991. First Variable, however, was not taken over by Arkansas regulators. Finally, the holding company also owned various real estate and investment management companies.

A holding company structure provides opportunities for an insurance company to diversify its business and increase efficiency by sharing administrative operations with affiliated companies. Also, a holding company can draw on its resources to provide capital infusions and financial support for a troubled insurance subsidiary. However, interaffiliate transactions may pose risks to an insurer's solvency. An insurer faces the risk that affiliates may not repay money borrowed from the insurer. Selling or transferring assets from affiliated companies to an insurer also places the insurer at risk of receiving poor quality assets. Moreover, financial problems within a holding company structure may adversely affect an insurer. An overleveraged holding company cannot provide financial support for its insurer and may attempt to divert funds from the insurer to assist ailing noninsurance affiliates.

Abusive interaffiliate transactions have contributed to several major life insurance failures. The Baldwin-United failure in 1983 was caused in large part by abusive interaffiliate transactions in which the holding company siphoned cash from its insurance subsidiaries. In an investigation of the 1991 failure of Guarantee Security Life, the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs learned that Guarantee Security allegedly used phony investments in unreported affiliates to mask its insolvency.¹ We previously testified that interaffiliate transactions drained the capital or masked the financial condition in four other failures: Executive Life of California, Executive Life of New York, First Capital, and Fidelity Bankers.²

Every state has statutory guidelines requiring insurers to disclose transactions with affiliated companies, and many states require prior regulatory approval to prevent abusive transactions. State regulators rely on off-site analyses of insurer-reported statutory financial statements and periodic on-site examinations to monitor insurer solvency. The National Association of Insurance Commissioners (NAIC) has a program for accrediting state insurance departments that meet its financial regulation standards. These standards define the laws and regulations, as well as various regulatory practices and procedures, that NAIC believes, at a minimum, are needed for effective insurance solvency regulation. The Massachusetts Division of Insurance was accredited by NAIC in December 1993.

Scope and Methodology

To determine whether interaffiliate transactions had a role in Monarch Life's financial problems, we reviewed the insurer's annual statutory financial statements filed with state regulators, financial statements filed with the Securities and Exchange Commission (SEC) by the insurer as well as its parent holding company, public reports of regulatory examinations of Monarch Life as of 1985 and 1988, and court proceedings pertaining to the receivership. We also met with Monarch Life officials and reviewed legal documents pertaining to the insurer's lawsuit against its former law firm and independent auditors.

¹Third Interim Report on United States Government Efforts to Combat Fraud and Abuse in the Insurance Industry: Enhancing Solvency, Regulation and Disclosure Requirements—A Case Study of Guarantee Security Life Insurance Company (Senate Report 103-29, Mar. 23, 1993). The report was based on the Subcommittee's hearings of April 29 and 30, 1992.

²Insurance Failures: Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurance Failures (GAO/T-GGD-92-43, Sept. 9, 1992).

To evaluate the adequacy of regulatory oversight by the Massachusetts Division of Insurance, we attempted to establish when Massachusetts regulators became aware that transactions with affiliated companies could endanger Monarch Life's solvency and what actions regulators took to protect policyholders. We reviewed financial analysis files of the Massachusetts Division of Insurance and interviewed regulatory officials responsible for managing the Monarch Life receivership.³ We also reviewed the workpapers from the examination conducted in 1989 for the 3-year period ending December 31, 1988 (hereafter "the 1988 examination"). The public report of the 1988 examination was issued in January 1990—10 months before the holding company's public disclosure of Monarch Life's financial problems. We sought to identify how examiners assessed Monarch Life's transactions with affiliated companies and whether the examination detected any problems. In particular, we attempted to determine whether the examiners followed guidance on investigating interaffiliate transactions recommended in NAIC's Financial Condition Examiners Handbook. Compliance with NAIC's examiners handbook is required for a state to be accredited.

We also examined Massachusetts insurance holding company laws in place at the time of the Monarch Life takeover, as well as amendments to those laws adopted in November 1993. We used NAIC data to determine to what extent Massachusetts had adopted NAIC's model Insurance Holding Company System Regulatory Act. This model—one of the minimum standards for accreditation—details regulatory authorities recommended by NAIC for monitoring an insurance company within a holding company structure. In particular, we considered whether Massachusetts had (1) requirements for prior approval of material transactions, (2) examination access to affiliated companies, and (3) sanctions for violating insurance holding company laws. NAIC had added such provisions to the model Insurance Holding Company System Regulatory Act following the Baldwin-United failure.

We obtained written comments on a draft of this report from the Massachusetts Division of Insurance and incorporated its comments where appropriate. (See app. I for the text of Massachusetts regulators' comments.) We did our work in Boston and Springfield, MA, between January 1993 and July 1994 in accordance with generally accepted government auditing standards.

³In August and October 1991, we also had discussions concerning Monarch Life with the then Massachusetts Insurance Commissioner.

The Holding Company's Financial Troubles Led to Monarch Life's Takeover

Financial troubles of the holding company endangered the solvency of Monarch Life and led to the regulatory takeover. In December 1989, the holding company reported \$72 million in losses on its real estate investments, including estimated costs for disposing of those assets. In May 1990, the holding company borrowed \$235 million from a consortium of banks and pledged its stock in Monarch Life as collateral for the debt.⁴ In addition to the stock pledge, the loan agreement included a net worth covenant requiring the holding company to maintain a minimum capital level.

As a result of the depressed real estate market, the holding company reported additional losses in 1990 on its real estate operations. In the third quarter report it filed with SEC in November 1990, the holding company disclosed that real estate losses of \$103 million caused a default on the net worth covenant in the loan agreement. At that time, the holding company informed the Massachusetts Division of Insurance that its real estate losses and resulting inability to repay money borrowed from Monarch Life had adversely affected the insurer's liquidity and capital resources. In the fourth quarter, the holding company reported additional losses of \$20 million and defaulted on the interest payment due on its loan. Further, the holding company disclosed that, because it had pledged its Monarch Life stock, it could lose control of the insurer to its bank creditors.

The Holding Company Diverted Funds From Monarch Life

In 1985, the holding company had begun operating a cash pool account to control and maximize use of available cash from its subsidiaries within the holding company group. According to the "Short-Term Investment Pool" agreement dated September 1986, Monarch Life was to transfer its available cash to the holding company's pool account at the end of each day.⁵ In return, Monarch Life was to receive a short-term interest rate on its cash funds, which previously had been placed in noninterest-bearing accounts. In 1986, the holding company reportedly had bank lines of credit totaling \$125 million, which were to guarantee the availability of Monarch Life's cash on a demand basis. Any subsidiary in the holding company system could borrow cash from the pool account at the holding company's short-term interest rate.

In effect, the pool account represented loans from Monarch Life to the holding company and other subsidiaries. These loans were not secured by

⁴The holding company also pledged the stock of six other subsidiaries.

⁵Regarding Monarch Life's insurance subsidiaries, Springfield Life participated in the cash pool, but First Variable did not participate at the direction of Arkansas regulators.

collateral, and Monarch Life had no controls to ensure that affiliates borrowing from the pool account could repay their loans. Table 1 shows how much the holding company owed to Monarch Life at year-end from 1985 to 1989. In 1985, before the pool was formally established, the insurer lent nearly \$7 million to the holding company. By the end of 1986, Monarch Life had a balance of \$70 million—approximately 59 percent of its reported capital and surplus—in the holding company's pool account. By year-end 1989, the insurer's balance in the pool account had grown by 57 percent to nearly \$111 million—about 80 percent of its reported capital and surplus. Given the size of its "investment" in the holding company's pool account compared with its surplus, Monarch Life's financial health depended on the holding company's ability to repay the cash.

Table 1: Percentage Growth in Monarch Life's Year-End Pool Account Balance and Its Balance as a Percentage of Capital and Surplus (1985-89)

Dollars in millions			
Year	Pool account balance ^a	Percent growth from past year	Percent of capital and surplus
1985	\$6.8	Not applicable	6%
1986	70.3	934%	59
1987	80.2	14	61
1988	101.6	27	72
1989	110.6	9	80

^aSpringfield Life also reported balances in the holding company's pool account of \$20 million in 1985, \$12.2 million in 1986, \$12.6 million in 1987, \$14 million in 1988, and \$15.1 million in 1989.

Source: Annual statutory financial statements and financial information provided by Monarch Life.

The pool account provided a means for the holding company to divert cash from Monarch Life. Instead of servicing short-term cash needs, the holding company used the insurer's cash to finance long-term real estate investments. However, the holding company did not have the financial resources to repay the insurer's cash. By September 1990, the holding company owed nearly \$165 million to Monarch Life and its subsidiary—equivalent to over 110 percent of Monarch Life's reported capital and surplus. In the third quarter 1990 report it filed with SEC, the holding company disclosed that it had discontinued the pool account and was trying to repay Monarch Life. Of \$157 million owed to Monarch Life and its subsidiary as of November 1990, the holding company partially repaid the balance by transferring three subsidiaries to Monarch Life.⁶ The holding company estimated the subsidiaries were worth \$60 million. In its

⁶The holding company also offset Monarch Life's \$34 million deferred commission liability owed to another holding company subsidiary.

1990 annual statutory financial statement, Monarch Life wrote off \$63 million of its balance in the pool account and nearly \$4 million on its holdings of common stock of the holding company.

Monarch Life Faced Additional Losses on Affiliated Real Estate Investments and Guarantees

At the holding company's direction, Monarch Life also invested directly in several affiliated real estate entities. In December 1989, Monarch Life and its two insurance subsidiaries invested \$53 million—equivalent to 38 percent of Monarch Life's reported capital and surplus in 1989—in an affiliated real estate limited partnership.⁷ According to Monarch Life officials and Massachusetts regulators, the holding company created the partnership because it did not have the liquidity to repay cash borrowed through the pool account. The partnership's assets had been transferred to the newly created partnership from the holding company's real estate affiliates, and the holding company, as the general partner, continued to control the underlying properties. The partnership served as a way for the holding company to transfer assets, including mortgage loans exceeding 75 percent of the properties' values, that would not qualify as legally permitted investments if held directly by Monarch Life. According to Monarch Life, the insurer and its subsidiaries lost \$34 million on the limited partnership.

In June 1990, Monarch Life paid \$33 million to purchase three bank loans on the marina joint venture of an affiliated real estate company. At that time, the real estate market in Massachusetts was depressed, and the marina units were not selling. The three loans had been overdue since March 1990, and the venture was on the verge of bankruptcy. The failure of the joint venture would have bankrupted the real estate affiliate and could have precipitated a chain of defaults under the holding company's various loans and lines of credit. Monarch Life's purchase of the three bank loans disguised the possible insolvency of the affiliate and potential credit crisis for the holding company itself. We question whether the investment—representing 33 percent of Monarch Life's reported 1990 capital and surplus—in a troubled real estate venture was in the best interest of the insurance policyholders. According to Monarch Life officials, the insurer lost nearly \$20 million as a result of its investment.

Monarch Life faced additional risk by acting as a loan guarantor for some of the holding company's real estate operations. As of December 1990, Monarch Life was committed to lend \$6 million to the holding company's

⁷The investment was funded by reductions in the pool account balances of Monarch Life and Springfield Life, as well as by cash from First Variable Life.

limited partnerships and had guaranteed mortgage loans for the holding company's real estate ventures totaling about \$69 million—\$14 million more than the estimated value of the underlying properties. According to the Massachusetts receivership petition in 1991, Monarch Life received little, if any, compensation for the loan guarantees, which were highly risky given the inadequate underlying collateral.

The Massachusetts Division of Insurance Was Unaware of the Problems Endangering Monarch Life

Until the holding company's disclosures in November 1990, the Massachusetts Division of Insurance was unaware of the interaffiliate transactions that depleted Monarch Life's assets and undermined its solvency. The statutory financial statements that Monarch Life filed with state regulators did not disclose information crucial for regulators to fully assess the risks of the insurer's transactions with affiliated companies. Further, the last triennial examination of Monarch Life did not detect the riskiness of the pool account transactions because examiners did not assess whether the holding company could repay the loans. Once the holding company disclosed that its inability to repay Monarch Life endangered the insurer's solvency, Massachusetts regulators responded swiftly to protect the insurer's policyholders.

Regulators Lacked Crucial Information About Monarch Life's Interaffiliate Transactions

Timely, accurate, and complete information about an insurer's assets is crucial for effective solvency regulation. If financial reporting does not fairly and promptly present an insurer's true condition, regulators cannot act quickly to resolve problems. Monarch Life—like all insurers domiciled in Massachusetts—was required to submit quarterly and annual statutory financial statements as well as annual audited statutory financial statements.

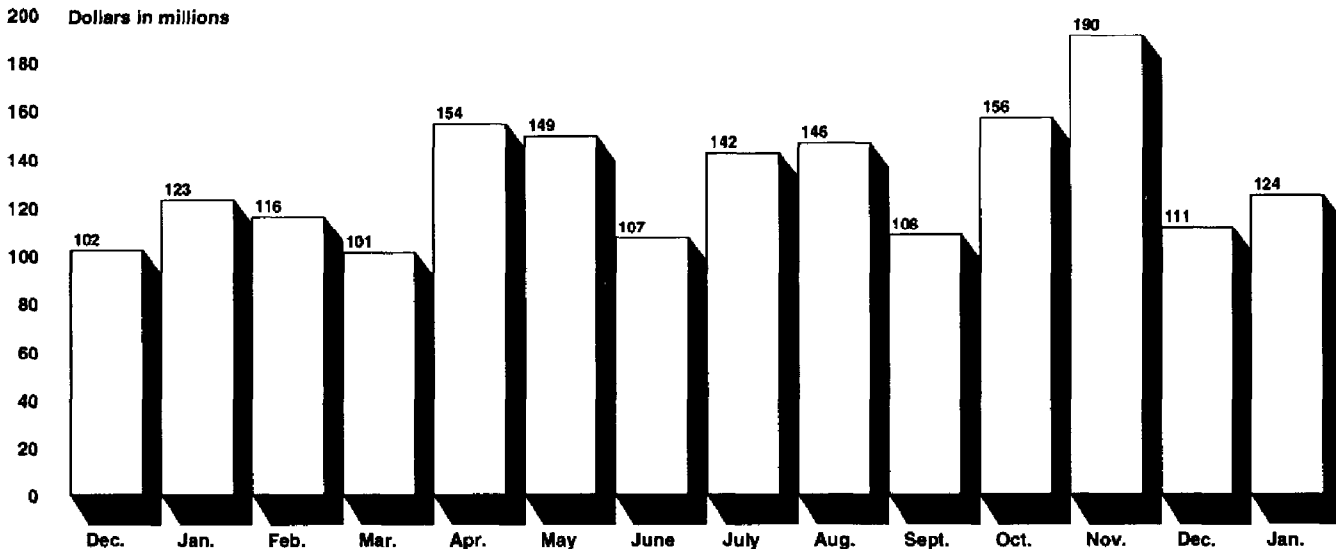
However, Monarch Life's statutory financial statements indicated neither the magnitude of its investments in affiliates nor the economic substance of the pool account. In its 1989 statutory financial statements, Monarch Life disclosed its purchase of the limited partnership from the holding company as an interaffiliate transaction but did not reveal that the partnership itself was a related party. In its 1990 statutory financial statement, Monarch Life did not indicate that its purchase of the marina bank loans resulted in its investment in an affiliated joint venture. Monarch Life reported its participation in the pool account as "Other

Long-Term Invested Assets”⁸ and did not identify these amounts as unsecured long-term loans to affiliated companies.

Moreover, statutory financial statements filed with Massachusetts regulators did not fully disclose the magnitude of Monarch Life's loans to the holding company. Monarch Life officials and Massachusetts regulators alleged that the holding company manipulated the pool account to lower the balances reported in Monarch Life's quarterly and annual statutory financial statements. Figure 1 shows the insurer's pool account balance at the end of each month from December 1988 to January 1990.⁹ During this time period, the pool account balance in each of Monarch Life's quarterly reports—March, June, September, and December—was lower than the monthly balances both preceding and following the quarter's end. The December balance of nearly \$111 million reported in Monarch Life's 1989 annual financial statement was sizably less than its November balance of nearly \$190 million. The \$111 million balance (80 percent of Monarch Life's capital and surplus at year-end 1989) did not trigger closer scrutiny by Massachusetts regulators, in part because the reported balance was less than \$125 million—the amount of the holding company's lines of credit which were to guarantee the availability of the insurer's cash on a demand basis. Monarch Life has alleged that the holding company drew down its lines of credit to manipulate the pool balances and did not disclose the pool's illiquidity.

⁸Other long-term invested assets are reported on Schedule BA of the life insurance statutory financial statement and include real estate partnerships and joint ventures.

⁹We chose this time period because 1989 represented a crucial point for the holding company: it reported \$72 million in real estate losses and discontinued several real estate operations at the end of that year.

Figure 1: Monarch Life's Monthly Balances in the Holding Company's Pool Account (December 1988 - January 1990)

Source: Financial information provided by Monarch Life.

Monarch Life's statutory financial statements also did not portray its full exposure to the pool account because Monarch Life was not required to consolidate the financial accounts of its wholly-owned subsidiaries. In accordance with Massachusetts statutory accounting practices, Monarch Life reported the statutory capital and surplus of its insurance subsidiaries as assets on its own statutory financial statements. Monarch Life reported its pool account balance of nearly \$111 million in its 1989 statutory statement, but its subsidiary, Springfield Life, also had a pool account balance of \$15 million at year-end. Whereas Monarch Life's pool account balance alone represented 80 percent of its capital and surplus, the combined exposure of the insurer and its subsidiary totaled 91 percent.¹⁰ Financial information consolidating details about the assets and liabilities of wholly-owned subsidiaries would have been useful to regulators monitoring Monarch Life's solvency.

¹⁰From December 1988 to November 1990, Monarch Life's combined monthly balance exceeded \$125 million, the amount supposedly guaranteed by the holding company's credit lines, in all but 4 months. These 4 months coincided with the filing of Monarch Life's 1988 annual statement and the first three quarterly reports for 1989.

The Last Triennial Examination Did Not Detect the Riskiness of the Pool Account

We reported in 1989 that most states required on-site examinations only once every 3 to 5 years, although regulators could examine a troubled insurer more frequently.¹¹ Regulatory examinations took months or even years to complete. According to NAIC's examiners handbook, the state of domicile is to lead the examination of a multistate insurer, and examiners from other states in which the insurer is licensed can participate. The final examination report is to be distributed to all states where an insurer is licensed and filed as a public document. We previously found that time lags between triennial examinations, as well as reporting delays, had impaired regulators' ability to evaluate financial deterioration and take corrective action in the case of other life insurance failures.¹²

By law, the Massachusetts Division of Insurance was required to examine the financial activities of domestic insurance companies at least once every 5 years, but the state's practice was to examine life insurers on a triennial basis. Massachusetts regulators examined Monarch Life as of 1985 and again as of 1988. The insurer was not due to be examined again until 1993 by law, or until 1991 on a triennial basis.

The public examination reports we reviewed did not reveal the problems with interaffiliate transactions that led to the regulatory takeover of Monarch Life. The public report of Massachusetts' 1985 examination of Monarch Life did not mention the pool account.¹³ The public report of Massachusetts' 1988 examination—issued in January 1990—listed Monarch Life's \$102 million balance in the pool account but did not discuss whether the balance was recoverable. The reported examination scope included "a general examination of the accounts and records of the subsidiaries" within the insurer's control.

According to the Special Counsel to the Receiver of Monarch Life, however, the 1988 examination did not detect the riskiness of the pool account transactions because the examiners did not follow examination policies and procedures. NAIC's examiners handbook identifies unsecured loans to affiliates as a potentially abusive transaction and suggests examiners verify that an insurer's cash accounts are not used for the

¹¹Insurance Regulation: Problems in the State Monitoring of Property/Casualty Insurer Solvency (GAO/GGD-89-129, Sept. 29, 1989).

¹²Insurer Failures: Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurance Failures (GAO/T-GGD-92-43, Sept. 9, 1992).

¹³According to Monarch Life officials, Vermont regulators questioned the lack of a debt instrument underlying the pool account in 1986 during an examination of Springfield Life. Subsequently, in September 1986, the holding company drew up a demand note and agreed to use its lines of credit to guarantee liquidity of the pool account.

benefit of affiliates. NAIC's examiners handbook also recommends confirming collateral for loans and obtaining information as to the financial capability of affiliated companies to repay material balances. Even though Monarch Life's pool account balance represented 72 percent of its capital and surplus in 1988, we saw no evidence in the 1988 examination workpapers that Massachusetts examiners assessed the holding company's ability to repay the pool account loans. The Massachusetts examiners verified that Monarch Life transferred cash in the amounts reported as of 1988, but the workpapers contained no evaluation of whether Monarch Life could recover its money.

In an October 1993 report on the Massachusetts Division of Insurance, the Massachusetts State Auditor found that the state's field examinations of insurance companies were ineffective. In a sample of 6 of 14 examinations completed in fiscal year 1990, state auditors found that 5 of the 6 sets of examination workpapers contained no evidence of an internal control assessment. The sixth set—those for Monarch Life—included limited control testing but no conclusions about control adequacy. Moreover, the regulatory examinations focused on account-by-account balances reported in the insurers' annual statutory financial statements and did not provide an overall assessment of solvency. In particular, the State Auditor cited the 1988 examination of Monarch Life as an example of the examination report describing each account balance but providing no conclusions about the insurer's solvency.

In its response to the State Auditor's report, Massachusetts indicated that its examination process has changed significantly since the receivership of Monarch Life in May 1991. In late 1991, Massachusetts hired a new deputy commissioner to oversee the examination and financial surveillance units and replaced the former examination managers with technically qualified professionals with insurance experience. Starting in 1993, Massachusetts was to implement a new examination handbook and increase supervisory review of examiners' work. NAIC's accreditation of Massachusetts in December 1993 signified that a review team determined, among other things, that Massachusetts was in compliance with NAIC's examiner's handbook. In its comments on this report, the Massachusetts Division of Insurance said that it had upgraded its examination capability by hiring more examiners and using independent auditors and actuarial firms to assist in examinations of large insurance companies.

Once Aware, Regulators Responded Swiftly to Protect Monarch Life Policyholders

Once the holding company disclosed that its financial condition endangered Monarch Life's solvency, Massachusetts regulators moved swiftly to protect the insurer's policyholders. In November 1990, the Division of Insurance ordered Monarch Life to cease payments to the holding company and began a special examination to assess Monarch Life's financial condition. Massachusetts regulators disapproved Monarch Life's request to pay a dividend of \$25 million to the holding company at year-end 1990. In December 1990, Monarch Life reduced its operations by selling \$3 billion in variable life insurance policies to another insurer. In a letter to the Massachusetts governor dated November 29, 1990, the Massachusetts insurance commissioner projected that the Division's "forceful actions will prevent any threat of insolvency for Monarch Life, but the situation will require continued vigorous regulatory action on our part over the next few months." At that time, Massachusetts regulators believed that the financial woes of the holding company would not have a direct effect on Monarch Life.

However, on the basis of the special examination results, Massachusetts regulators initiated the receivership on May 30, 1991, in order to safeguard Monarch Life's assets for policyholders. Acting on behalf of Monarch Life, the Massachusetts Insurance Commissioner, as Receiver, filed an involuntary bankruptcy petition against the holding company in the United States Bankruptcy Court on May 31, 1991. Under the bankruptcy reorganization, the former holding company's bank creditors became the majority shareholders of the reorganized holding company. As part of the reorganization, Monarch Life was released from court-supervised receivership in September 1992 but remained under the close supervision of the Massachusetts Division of Insurance.

Monarch Life ceased selling new life insurance and annuities during 1992. Monarch Life also ceased selling disability insurance in June 1993 because of higher than expected losses. On the basis of a special actuarial examination conducted as of September 1993, Massachusetts regulators directed Monarch Life to increase its insurance loss reserves and sell its subsidiary, First Variable, to increase liquidity and capitalization. Because the bank shareholders objected to the sale, which was crucial to the insurer's recapitalization, Monarch Life's financial condition was deemed unsound, and Massachusetts regulators put the insurer back in receivership in June 1994.

Interaffiliate Transactions Were a Regulatory Blind Spot

In our 1992 testimony about four large life insurance failures, we reported that interaffiliate transactions of insurance companies were a regulatory blind spot.¹⁴ State regulators did not regulate either the parent holding companies or the noninsurance affiliates and subsidiaries of the failed insurers. Instead, state regulators were to evaluate and control the insurers' transactions with affiliated companies. In the case of Executive Life, California regulators could not effectively assess interaffiliate transactions and protect policyholder interests because Executive Life repeatedly failed to report and secure approval for transactions with affiliated companies.

Massachusetts regulators relied on insurer-reported data to assess whether Monarch Life's transactions with affiliates were fair and reasonable. Under Massachusetts laws, Monarch Life was required to file registration statements describing the financial condition of the holding company and the identities of all companies within the holding company system, as well as reports of material transactions. According to Monarch Life officials and Massachusetts regulators, however, the insurer and its parent holding company repeatedly failed to comply with Massachusetts holding company reporting requirements. As a result, Massachusetts regulators were unaware of risky interaffiliate transactions that depleted Monarch Life's assets and undermined its solvency.

Financial information about the overall condition of a holding company can be useful in anticipating whether the holding company's leverage or asset quality problems might lead to financial trouble for its insurance subsidiary. However, the consolidated financial statements received by Massachusetts regulators were of limited use in assessing Monarch Life's transactions with affiliated companies. First, transactions within the holding company system were netted to zero on a consolidated basis. Monarch Life has alleged that, as a result, the pool account was not revealed in the holding company's consolidated financial statements before 1990. Also, the holding company financial statements were prepared in accordance with generally accepted accounting principles, which were not comparable to the statutory accounting practices used by Monarch Life. In its 1992 report on state insurance solvency regulation, the Advisory Commission on Intergovernmental Relations (ACIR)¹⁵ concluded that

¹⁴GAO/T-GGD-92-43.

¹⁵ACIR is an independent, bipartisan commission created by Congress to monitor the American federal system and recommend improvements.

"Intercompany transactions and intermingling of assets make it nearly impossible to estimate the solvency of an insurer without looking at the various entities that are a part of the holding company, including the parent. Effective regulation of insurance holding company systems requires state regulators to review consolidated financial statements with uniform accounting standards and to examine the financial transactions among the parent holding company and its affiliates as a unitary economic enterprise."¹⁶

At the time of the Monarch Life takeover in 1991, Massachusetts lacked the authority, recommended under NAIC's model Insurance Holding Company System Regulatory Act, to prevent abusive interaffiliate transactions. In Massachusetts, only large dividends—those exceeding the greater of 10 percent of policyholder surplus or net gain from operations for a life insurer—required prior regulatory approval. NAIC's model recommends prior approval not only for large dividends but also for any transaction exceeding 3 percent of a life insurer's admitted assets. Massachusetts could request that Monarch Life produce records and accounts pertaining to interaffiliate transactions but lacked the authority recommended by NAIC to examine the affiliates. Massachusetts also lacked the authority to impose sanctions for violating insurance holding company laws.

In November 1993, Massachusetts expanded its insurance holding company legislation to provide greater regulatory authority over an insurer's transactions with affiliated companies. Massachusetts regulators now have greater authority to prevent potentially abusive transactions beforehand, rather than trying to recover money after a transaction has occurred.¹⁷ Massachusetts regulators gained authority to examine affiliates' records if an insurer fails to produce data about interaffiliate transactions. Massachusetts also added civil and criminal penalties for violating holding company reporting and approval requirements. NAIC's accreditation of Massachusetts in December 1993 signified that a review team determined, among other things, that Massachusetts holding company regulations were "substantially similar" to NAIC's model Insurance Holding Company System Regulatory Act.¹⁸

¹⁶Advisory Commission on Intergovernmental Relations, State Solvency Regulation of Property-Casualty and Life Insurance Companies, Dec. 1992, p. 29.

¹⁷Massachusetts laws also now specify that amounts owed by an insurer's stockholders are inadmissible as an asset unless secured by sufficient approved collateral.

¹⁸In Insurance Regulation: The National Association of Insurance Commissioners' Accreditation Program Continues to Exhibit Fundamental Problems (GAO/T-GGD-93-26, June 9, 1993), we reported that NAIC has not specified criteria defining "substantially similar."

We support state adoption of the minimum authorities recommended under NAIC's model Insurance Holding Company System Regulatory Act as an important step towards improving regulatory oversight of an insurer within a holding company. However, even the best holding company reporting requirements cannot prevent dishonesty. Regulators' ability to enforce Massachusetts insurance holding company laws still relies on prompt and complete disclosure of an insurer's transactions with affiliated companies. Untimely or incomplete disclosure can hinder regulators' ability to protect an insurer from potentially abusive interaffiliate transactions.¹⁹ Since a holding company's operations may be the cause of a subsidiary insurer's solvency problems, total reliance upon the insurer and its holding company to disclose the nature and extent of potentially abusive transactions is not prudent.

On-site examinations are regulators' primary way to verify insurer-reported information and detect violations of holding company reporting and approval requirements. To adequately assess the consequences of an insurer's transactions with affiliated companies, examiners must recognize the economic substance of transactions and use procedures for investigating interaffiliate transactions recommended in NAIC's examiners handbook. The longer the interval between examinations, the greater the opportunity a holding company has to engage in potentially abusive transactions without prompt regulatory detection.

Conclusions

Before November 1990, Massachusetts regulators were unaware that Monarch Life would be unable to recover cash diverted by the holding company into risky real estate investments. In part, Massachusetts regulators were unaware because Monarch Life did not disclose the extent and riskiness of its transactions with affiliated companies. Deficiencies in the last triennial examination of Monarch Life also contributed to regulators overlooking the riskiness of Monarch Life's dealings with affiliated companies.

Since the Monarch Life receivership in 1991, Massachusetts has increased regulatory safeguards against potentially abusive transactions between an insurer and affiliated companies. However, the regulatory approach continues to rely on a holding company system to reveal potentially abusive transactions involving an insurance subsidiary. The case of Monarch Life illustrates how an insurer's failure to comply with holding

¹⁹Under new fraud provisions enacted by Congress in 1994, to knowingly file a false financial statement or report with insurance regulators is a federal crime (18 U.S.C. sections 1033-1034).

company reporting requirements can create a regulatory blindspot. Without independent evaluation of insurer-reported data, insurance regulators may not detect problems within a holding company system until losses endanger insurer solvency.

Agency Comments

In commenting on a draft of this report, the Massachusetts Division of Insurance said the report was fair and accurately addressed an area deserving of regulatory focus. The Division also provided information about improvements in its examination process implemented since 1991 when Monarch Life was placed in receivership. We revised the text to reflect this information and to incorporate where appropriate other technical corrections provided by the Massachusetts Division of Insurance.

We are sending copies of this report to interested congressional members and committees, the Massachusetts insurance commissioner, and NAIC's Executive Vice President. We also will provide copies to others upon request.

This report was prepared under the direction of Lawrence D. Cluff, Assistant Director for the Insurance Group, who may be reached on (202) 512-8023 if you have questions concerning the report. Other major contributors were MaryLynn Sargent, Evaluator-in-Charge, and John McDonough, Senior Evaluator.

Sincerely yours,



Thomas J. McCool
Associate Director, Financial
Institutions and Markets Issues

Comments From the Massachusetts Division of Insurance



PRISCILLA H. DOUGLAS
SECRETARY
LINDA RUTHARDT
COMMISSIONER

THE COMMONWEALTH OF MASSACHUSETTS
EXECUTIVE OFFICE OF CONSUMER AFFAIRS
DIVISION OF INSURANCE
470 ATLANTIC AVENUE
BOSTON, MA 02210-2223
(617) 521-7794
TTY/TDD (617) 521-7490

February 13, 1995

MaryLynn Sergent
Evaluator - In - Charge
United States General Accounting Office
Room 3858
441 6 Street NW
Washington, D.C. 20548

Dear Ms. Sergent:

We appreciate your providing us with an opportunity to review the GAO's draft report entitled "Observations on the Receivership of Monarch Life".

The draft report has been reviewed here at the Division of Insurance, by our Special Counsel and by Monarch Life management. Our collective view is that the GAO report is fair and accurately addresses an area deserving of regulatory focus. Our comments are all of a technical nature and are indicated on the enclosed draft.

If you wish to discuss any of our comments on the draft, please feel free to call.

Very truly yours,

A handwritten signature in dark ink, appearing to read "Dan".

Daniel R. Judson
Deputy General Counsel

Enclosure

cc: Linda Ruthardt
Kevin McAdoo
John Coulton
David Leslie

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1168
700 A St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000 or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (301) 258-4097 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

**United States
General Accounting Office
Washington, D.C. 20548-0001**

**Bulk Mail
Postage & Fees Paid
GAO
Permit No. G100**

**Official Business
Penalty for Private Use \$300**

Address Correction Requested

